



# Transfer Pricing

July 2018 newsletter

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# Introduction

Dear friends,

Considering the relevant developments occurring in the international landscape in the last few years, transfer pricing still is and will continue to be also in the future one of the hottest topics for multinational enterprises to manage their supply chains and – at the same time – their relationships with tax administrations.

Accordingly, we all have a great opportunity to strengthen not only our relationship with clients being next to them in creating value, but also the chance to have Nexia competing with major consultancy networks in global and complex engagements.

For these purposes, we are now launching the first issue of the Nexia Transfer Pricing Newsletter: it – through its quarterly publications – will provide insights on most relevant developments in the transfer pricing and tax value chain areas in the aim of fostering knowledge sharing and increase global view over crucial topics that need to be handled in a cross-border perspective.

We hope this publication will stimulate your business and look forward to receive your contributions for next issues. We encourage you to distribute this newsletter to your team members as well as your clients to witness - once more - that Nexia is "Closer to you".

Thank you and best regards,

Nexia Transfer Pricing Business Group.

# China

## China Transfer Pricing Regulation Review

Since June 2016, China's State Administration of Taxation (SAT) has responded to the OECD BEPS transfer pricing recommendations through release of two primary regulatory documents, to include Announcement [2016] #42, Improved Administration of Related Party Declarations and Contemporaneous Documentation, and Announcement [2017] #6, Administrative Measures on Special Tax Investigation, Adjustment and Mutual Agreement Procedures. While in some cases Announcement 42 increases the complexity of related party transaction reporting by global companies operating in China, many of the provisions clarify points that were previously quite vague, and overall the regulations mostly bring China's transfer pricing documentation requirements into line with the BEPS recommendations. Meanwhile, Announcement 6 consolidates a number of previously released regulations related to outbound payments for royalties or service fees, and introduces many of the BEPS concepts into the regulations. The scope of the announcement includes transfer pricing, thin capitalization, controlled foreign companies (CFCs) and general anti-avoidance rules (GAAR), while also detailing the rationale and methods used in transfer pricing audits and tax investigations. A brief summary of key points in the regulations follows.

## Related Party Transactions Clarified

Announcement 42 provisions mandate that all resident and non-resident companies subject to China corporate taxation annually file an updated version of a Report of Yearly Related Party Business Transactions. Correspondingly the definitions of related party relationships and transactions have been clarified and broadened, thereby making it simpler to determine whether or not a related party relationship exists. Related party transaction definitions include a new category covering financial assets transfers. The financial intermediation category has expanded to include long-term and short-term borrowing, surety bonds, accrued interest advances, deferred payables and receivables, and similar transactions. The related party service transaction category has been expanded to include market survey, marketing planning, agency, design, consultancy, administration, technical services, contract R&D, repair and maintenance, legal services, financial management, audit, recruitment, training, centralized procurement and so on.

## Contemporaneous Documentation and Country-by-Country Reporting

Announcement 42 also details new contemporaneous documentation requirements, to include how the documentation is structured, the contents of the documentation, the thresholds at which documentation is required, and the deadlines for document preparation. As per the BEPS Action 13 report, contemporaneous documentation shall now include a Master File and a

Local File, as well as "special documentation" that may be required with respect to Cost Sharing Arrangements, or where thin capitalization thresholds are exceeded.

Additionally, there are now three general cases in which country-by-country (CBC) reporting is required. In the first case, a resident ultimate holding company of a multinational group that has consolidated financial statements exceeding RMB 5.5 billion for the previous year must file a CBC report. A CBC report will be required where a multinational group designates a China resident company such responsibility. Lastly, where any taxpaying entity in China is under special tax investigation, CBC reporting is required even if the entity does not fall into either of the two cases listed above.

## Special Tax Investigations

Announcement 6 clearly specifies factors that may trigger special tax investigations, to include companies that: engage in a large number and/or varied types of related party transactions; incur long-term losses or low profits; have transactions with related parties in low tax jurisdictions; fail to prepare contemporaneous documentation as required; exceed standards for debt to equity ratio; have certain characteristics related to CFCs; or have tax planning arrangements that have no reasonable business purpose.



### Transfer Pricing Methods

Announcement 6 allows that in any comparability analysis, any of the OECD acceptable transfer pricing methods may be used, as well as other arm's length methods which reflect the principle that "the place where profit and economic activities occur matches the place of value creation." Each of the methods is described in detail with respect to when a given method should be used, the factors that should be considered in choosing, and how prices shall be calculated.

### Royalties and Service Fees between Related Parties

Announcement 6 mandates that any royalties or licensing fees paid to related parties must be commensurate with provable economic benefits to the party paying the fees. Likewise, service transactions between related parties must be beneficial, willingly received by the recipient, and priced at arm's length. A list of services considered non-beneficial to the recipient is included in the announcement. If determined to have no economic benefit to the recipient, deductibility of royalties and/or service fees is not allowed.

### Conclusion

While remaining questions linger, the SAT announcements introduced above go a long way toward providing unambiguous regulatory guidance with respect to transfer pricing and related issues for both taxpayers and in-charge tax officials throughout China. As a result, it is predicted that tax investigation and adjustment practices in transfer pricing cases will be increasingly standardized from one tax bureau to the next. Likewise the reasonably close adherence to the related BEPS deliverables should help global businesses better understand how to plan and implement transfer pricing policies and practices, as well as what is required to avoid special tax adjustment investigations in most types of related party transactions.

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# India

## The Crucial Point - 'Appropriate use' of CbCR information

The Action 13 of OECD's BEPS project introduced three-tiered approach to transfer pricing documentation, consisting of:

1. Master File, containing Information relevant for all members of the Multinational Enterprise ('MNE') group
2. Local file, referring specifically to material transactions of the local taxpayer
3. Country by Country Report (CbCR), containing information relating to the global allocation of the group's income and taxes, together with indicators of the location of economic activity within the group (CbCR information)

### OECD's stand on use of CbCR information

The Action 13 report (at para 56) described the underlying conditions for obtaining and use of CbCR:

- Confidentiality
- Consistency
- Appropriate use

Later, in September 2017, the OECD also released supplementary guidance, provided indicators of appropriate use, and discussed the instances, which shall be considered as 'inappropriate use' of CbCR information. The said guidelines clarified that tax authorities can use CbCR information in a) planning a tax

audit or b) basis for making further enquiries.

The guidelines also discussed at length the consequences of non-compliance with the appropriate use condition and designed a checklist, for the use of jurisdictions in order to effectively implement the appropriate use restrictions in their domestic rules and processes.

### Guidelines from Indian revenue authority

Recently, the CBDT (apex Tax body in India) has released guidelines for all tax officers in India on 'appropriate use' of CbCR information. The said guidelines are principally a shadow reflection of OECD guidelines referred to above. The key highlights are as below:

- Appropriate use of CbCR  
In line with the OECD guidance on appropriate use, the CBDT has instructed that CbCR information shall be used for following purposes:
- High level TP risk assessment – The Risk assessment unit i.e. CRAU may provide perspectives of potential risks from TP arrangements between Indian taxpayer and its foreign AE, which may necessitate further examination by the TPO. However, it has been clarified that enquiries by the TPO may not be restricted only to the potential risks identified by the CRAU.
- Assessment of other BEPS related risk – The OECD Action 13 report and the CBDT guidelines does not contain specific guidance with respect to the ability of the tax authorities to use information in CbCR for assessing other BEPS related risks. However, the September 2017 guidance of the OECD as well as the CBDT Guidelines suggests that the CbCR information

may be used to identify indicators of possible tax risks unrelated to transfer pricing. The tax officers may send enquiries during the tax assessment for further examination of such risks identified through CbCR information. However, it has been clarified that the information gathered from CbC reports cannot constitute conclusive evidence that the taxpayer is engaged in any form of BEPS.

- Inappropriate use  
The use of information contained in CbC report by tax authorities shall be considered inappropriate, if:
  - a. The information is used as a substitute for detailed transfer pricing analysis; and
  - b. The information is used as the only material to propose transfer pricing adjustment
- Confidentiality of the CbCR  
The CBDT instructions emphasizes that maintaining confidentiality of the information received in the form of CbCR through permissible routes is legal obligation and the guidelines on maintaining confidentiality shall be strictly followed by all the officers.
- Monitoring, Control and Review  
The CBDT has instructed that the use of information in transfer pricing audits shall be appropriately monitored and breach of 'appropriate use', if any, shall be reported to Competent Authority of India, who in turn, is committed to disclose such breaches to the Co-ordinating body secretariat of the OECD as per the OECD guidelines.

**Our Principle Comments**

The condition of 'appropriate use' of CbCR information was one of the top most expectations of MNEs from OECD and following jurisdictions, considering the sensitive nature of information involved in the CbCR. It is pertinent to note that the CbCR information will provide tax authorities for the first time with a full breakdown of MNE's revenue, profits, tax and other attributes by tax jurisdiction, significantly increasing the volume and scope of information available to them. Therefore, MNEs can anticipate that with access to the CbCR information the transfer pricing assessments in India are likely to be more intense and it may potentially create new litigation trend in India. Therefore, it is imperative that the MNEs prepare themselves by doing high level risk assessment of CbCR information submitted / to be submitted to the tax office.

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# European Union

## Year-end adjustments on transfer pricing: ECJ denies use for custom purposes

On 20 December 2017, the Court of Justice of the European Union (ECJ) announced its decision (preliminary ruling) on the Hamamatsu case (C-529/16): in short, the case under examination by the ECJ concerned the possibility of using for the purposes of restatement of the customs value (for the "Transaction Value" method) the year-end adjustments in relation to transfer pricing with retroactive effect on intra-group transactions carried out in the previous months. In brief, ECJ had determined that the European Union provisions related custom matters do not allow, in order to correct the customs values previously declared at the time of imports, price adjustments (carried out after closing of the year) with retroactive value from the beginning of the same tax period (regardless of whether they are positive or negative) in case these changes had not been quantified ex-ante or at the time of the original execution of the transactions.

### The case

The present case starts with the request for reimbursement of custom duties presented to the competent German office by the company Hamamatsu Photonics Deutschland GmbH ("Hamamatsu Germany"), a local branch of the Japanese group Hamamatsu Photonics ("Hamamatsu Japan"). Hamamatsu signed a preliminary agreement (Advance Pricing Agreement - APA) on

transfer prices with the German Tax Authority selecting the Residual Profit Split as a methodology for setting the prices within the group. In particular, the transfer pricing policy concerning the sale of finished products from the Japanese holding to the German subsidiary, provided a price adjustment mechanism (so called year-end adjustment) if at the end of the tax period the transfer prices applied had determined - for the European branch - a margin outside (lower or upper) a range of values resulting from a specific benchmarking analysis. Likewise, the same methods of "temporary" determination of transfer prices (during the year, before the calculation of the adjustment) were also used to identify the value of the goods sold at the time of importation. At the end of 2010, Hamamatsu group realized that the operating margin of the German branch was lower than the range agreed in the APA: it was therefore necessary to reduce the transfer prices adopted in the previous months in order to bring back the marginality of Hamamatsu Germany, for this tax period, within the range of market profitability identified through benchmark analysis.

Following the adjustment, during 2012 the German branch of the group decided to submit a specific request for reimbursement of customs duties which - on the basis of the calculations made for income tax related to transfer pricing - resulted to have been paid in excess.

The German custom authorities rejected the request, arguing that the price adjustment was a total amount,

without any specific allocation being made to the individual intra-group transactions that took place earlier in the year. Hamamatsu appealed against the decision of the custom authorities before the competent tax commission of Munich, which - given the complexity of the case and the absence of specific legal provisions - suspended the proceedings, submitting the controversy to the ECJ, asking for official interpretation regarding (i) the possibility of using transfer pricing to determine the custom value of the goods if the prices are subject to any subsequent adjustment after the end of the tax period and (ii) if so, whether subsequent corrections (for carrying out of the operations) of price can be asserted also for the purpose of a redetermination of the custom value.

The ECJ - resuming the provisions of the Custom Code (see articles 29-33 and 78) takes the opportunity to underline that the Transaction Value method based on the value attributed to goods at the time of importation is not passable if the value of the same goods cannot be identified with certainty from the moment in which they are released for free movement. In such cases, alternative methods should be used.

Furthermore, ECJ states that the Transaction Value method should take into account all elements that characterize the goods and that are subject to economic valuation (for example, sales commissions, transport costs, royalties). Once the goods have been put into circulation, the valuations obtained with the application of the Transaction Value method can be corrected only under certain specific circumstances like - for example - an adjustment in relation to quality defects or faulty workmanship discovered after the marketing of these goods.

Therefore, the position taken from the ECJ is that, for the determination of the import value of goods for customs purposes, a method that involves the invoicing of an initial value subsequently modified due to a total adjustment (flat-rate) operated after the end of the financial year is not viable.

### **Preliminary considerations**

The ECJ decision, which is an isolated case so far, is short and concise and does not provide any detailed analysis as to a possible convergence of the methodologies applicable for the determination of transfer prices (for the purposes of direct taxation) and valuation for custom purposes.

However - at least in the present case - it seems to exclude (or not to contemplate) a connection between the assessments made for customs purposes and the methodologies applied for transfer pricing purposes to satisfy the arm's length principle.

The decision of the ECJ on the Hamamatsu case certainly deserves further investigation both in terms of European customs legislation and in light of the intense

work carried out in recent years by the World Customs Organization on the subject of a greater desirable convergence between transfer pricing guidelines and custom principles.

However, multinational groups that have significant flows of import-export operations between related entities will have to monitor the future developments that the decision above may have at the level of tax administrations to assess possible economic-financial impacts as well as the possibility of a structural revision of infra-group flows and related transfer pricing policies.

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# Georgia

## Transfer Pricing regulations in Georgia

From 2011 in Georgian tax code were introduced articles referring to Transfer Pricing matters and in 2013 minister of finance of Georgia introduced instruction #423 on pricing international controlled transactions, which is based on OECD Guidelines 2010. The same year Revenue Service of Georgia created Transfer Pricing division in Audit department, which is responsible for auditing Georgian entities engaged in international controlled transactions.

Georgia is not a member state of OECD, but local TP regulations follow OECD Guidelines and the matters that are not regulated by the Instruction shall be regulated by the OECD Guidelines, as it's stated by the Instruction.

Transfer Pricing rules in Georgia are applicable to companies which have carried out transactions with non-resident related entities and/or entities registered in preferential tax jurisdictions. For the purposes of Georgian tax code preferential tax jurisdictions are determined by Decree #615 of the minister of finance of Georgia and are those which have less than 5% rate of tax on income; For purposes of Georgian Transfer Pricing regulations two entities are related if:

- a) one person directly or indirectly participates in the management, control or capital of the other person.
- b) the same persons directly or indirectly participate in the management, control or capital of two persons.

According to the related articles in Georgian Tax Code a person participates in the management, control or capital of an enterprise if he/she directly or indirectly owns over 50% of an enterprise. Furthermore, two persons shall be deemed related if facts prove that business decisions of one of them is controlled by the other or the total amount of loans received by an enterprise from or under guarantee of the other entity/person is more than 50 percent of the enterprise's total assets.

Georgian TP instruction determines 5 methods of transfer pricing as it's suggested by OECD Guidelines:

- Comparable Uncontrolled Price Method
- Cost-Plus Method
- Resale Price Method
- Transactional Net Margin Method
- Profit Split Method

The three traditional methods have first priority over the TNMM and profit split methods. Some other method can be applied if abovementioned methods can not provide reliable results and such other method yields a result consistent with that which would be achieved by independent enterprises engaging in comparable uncontrolled transactions under comparable circumstances. In such cases, a taxpayer shall bear the burden of proof that the abovementioned requirements have been satisfied. A taxpayer should select the most appropriate method according to the nature of its business, comparability factors and the

availability of relevant information. If there is a lack of internal comparables or these internal comparables are not reliable enough, the taxpayer may use external comparables from the foreign markets. It's acceptable to use information of foreign comparable companies in order to determine arm's length range but in case of differences between economic or other factors, comparability adjustments should be made in accordance with the TP instruction.

There is not determined any specific form(tax return) for submitting information regarding controlled transactions. And taxpayers which have carried out controlled transactions are not automatically obliged to submit details of the transaction to the tax authority. However, in profit tax return taxpayers shall indicate if they have carried out controlled transactions and afterwards they may receive an official request from tax authority to prepare and provide TP documentation. Full transfer pricing documentation shall be provided within 30 days upon official request.

For all controlled transactions transfer pricing documentation should contain:

- Organizational structure of the tested party and information regarding parties relevant to the controlled transaction.
- Description of business operations of the tested party including an analysis of the economic factors that may affect prices of goods and/or services it provides.

- Description of the controlled transaction, including comparability factors and details of the group's transfer pricing policy which the Georgian entity belongs to.
- Description of applied TP method and an explanation why this method was selected;
- Comparability analysis, including: a description of the comparable uncontrolled transactions that were utilized, explanation of the basis for rejection of any potential internal comparable uncontrolled transaction; description of any comparability adjustments applied;
- Conclusion, with detailed explanation of why the company thinks that prices applied in controlled transactions are in line with arm's length principle;
- Financial information of the tested parties;
- Details of any APAs relevant to the controlled transactions;
- Any other information that may affect conclusion that prices applied between related parties are in accordance with arm's length principle.

There are no penalties applicable if a company doesn't submit transfer pricing documentation in time, but they shall expect that controlled transactions are examined by the tax authority and if the prices are not within arm's length range, additional taxes may be accrued.

BEPS 13 is not implemented yet and TP instruction is based on OECD Transfer Pricing guidelines 2010, therefore Georgian entities are not required to submit Master file or CbC Report.

According to the TP instruction unilateral, bilateral and multilateral Advanced Pricing Agreements are applicable but there is no practice if issuance yet and the fee of APA is not determined.

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# Germany

## ECJ Decision Hornbach-Baumarkt AG Is the German correction standard for transfer prices being eased?

Case-law on transfer prices is comparatively rare in Germany. However, when it occurs, it frequently concerns fundamental legal matters. A current decision of the European Court of Justice could cause a central standard of German foreign transaction tax law to alter (ECJ Decision of 31 May 2018, C-382/16, Hornbach-Baumarkt AG).

### Essence

In transactions with foreign related parties, companies must follow the arm's length principle. If companies within an multinational group do not conduct themselves in harmony with the arm's length principle because the agreed prices (transfer prices) deviate from what independent third parties would have agreed, the incomes of the Germany-based companies are to be corrected (increased) accordingly. Such relation exists in case a tax payer holds shares in a company of more than 25 % directly or indirectly or the ability of controlling influence on another company. The central standard for this is section 1 of the German Foreign Tax Act (FTA / Aussensteuergesetz) and applies exclusively to cross-border transactions. Whether the regulation infringes upon European law has long been a controversially disputed topic. The decision of the European Court of Justice (ECJ) is likely to intensify this debate further.

### Facts of the case

German-based Hornbach-Baumarkt AG had an indirect, 100% participation in two Dutch corporations. The two foreign companies had negative equity and were dependent on bank loans for the continuation of their business operations and for the funding of intended investments. The financing bank had made the granting of the loans dependent on factors including the issue of a letter of comfort by the AG. Subsequently, the AG issued these letters of comfort, without demanding remuneration for this from its subsidiaries. The tax office assumed that unrelated third parties would have agreed liability compensation under the same circumstances and therefore increased the income of the AG pursuant to section 1 FTA by the amount of the assumed liability compensation. After an unsuccessful appeal, the AG instituted legal proceedings. The Finance Court of Rheinland-Pfalz has doubts about the compatibility of section 1 FTA with European freedom of establishment and therefore presented the matter to the ECJ.

### Decision

The ECJ considers section 1 FTA to be, in principle, compatible with European law. According to the court, although the rule intervenes in freedom of establishment, as it treats cross-border transactions differently (more strictly) than purely domestic transactions, such a distinction is objectively justified, as it ensures a balanced distribution of taxation authority between the member states. The ECJ had already made a similar decision on a comparable regulation in Belgian tax law in 2010 (SGI case). However, the current decision contains a significant

limitation: in the opinion of the ECJ, it is necessary that the tax-paying entity be granted the opportunity to demonstrate business (non-tax) reasons for concluding the specific transaction. Otherwise, according to the court, this standard would infringe upon the principle of proportionality. Whether such a demonstration of business reasons is possible in the present case must be examined by the Finance Court in the next step.

### Consequence

The statements of the ECJ regarding the business reasons are particularly remarkable. According to the court, such business reasons that result from the AG's shareholder status in relation to the subsidiaries – for example, its own interest in the business success of the companies and thus the prospect of future profit distributions or the financing responsibility as shareholder – are also to be permitted. So far, the German fiscal authorities have always rejected this consideration, precisely because it does not correspond to the arm's length principle. Therefore, it remains to be seen, with interest, how the Finance Court (and, as a consequence, possibly also the Federal Fiscal Court of Finance) will utilise this template. In the meantime, the decision provides the opportunity to present business reasons in case transfer prices are challenged by German tax authorities with reference to Section 1 FTA.

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# Italy

## New Transfer Pricing Era

### Revision of the transfer pricing framework

The Decree of April 24, 2017 No. 50 converted by the law of June 21, 2017 amended the article 110 paragraph 7 of Presidential Decree No 917/1986 – i.e. the Corporate Income Tax Code (Tuir), milestone in the Italian law of transfer pricing. Following this change made, on 14 May was published the Decree of the Ministry of Finance that represents the realization of the first step of an overhaul of the domestic discipline. The content of Decree consists of nine articles, it is summarized below.

In Article 1 is clarified the scope in which the arm's length principle applies, that is between intercompany transactions in foreign countries and Article 2 lists the definitions of the terms recurring in Decree.

Then, Article 3 focuses on comparability, an essential theme for the analysis and drafting of the Country File. Subsequently, Article 4, after a brief listing of the 5 methods dictated by the OECD Guidelines, permits the adoption of alternative methods provided that the taxpayer can demonstrate that it would be impossible to adopt the other methodologies.

Article 5 specifically states that the arm's length principle must be applied to each transaction individually, except for operations homogeneous or complementary.

With Article 6, there is a specific definition of arm's-length range since there is no reference for determining the exact point to which any other result is considered not in line with the market.

Then, Article 7 introduces a simplified procedure for calculating the relevant remuneration based on 5% markup on direct and indirect costs for low-value-adding services.

Article 8, considering the penalty protection regime and the required contents of documentation, offers clarifications on the suitability of masterfile and country file which – in brief – must necessarily provide the tax authorities all fundamental elements essential to enable inspectors to carry out in-depth analyses of the transfer prices applied. The presence of inaccuracies in the TP documentation shall not invalidate the document in case it is basically complete and compliant with the Central Revenue guidelines. In any case, the tax office is allowed to ask for supplementary information.

Lastly, Article 9 refers to one or more acts (e.g., circular letters, official interpretations, etc.) of the Commissioner of the Revenue Agency for the issue of further provisions and operative instructions on the most relevant topics.

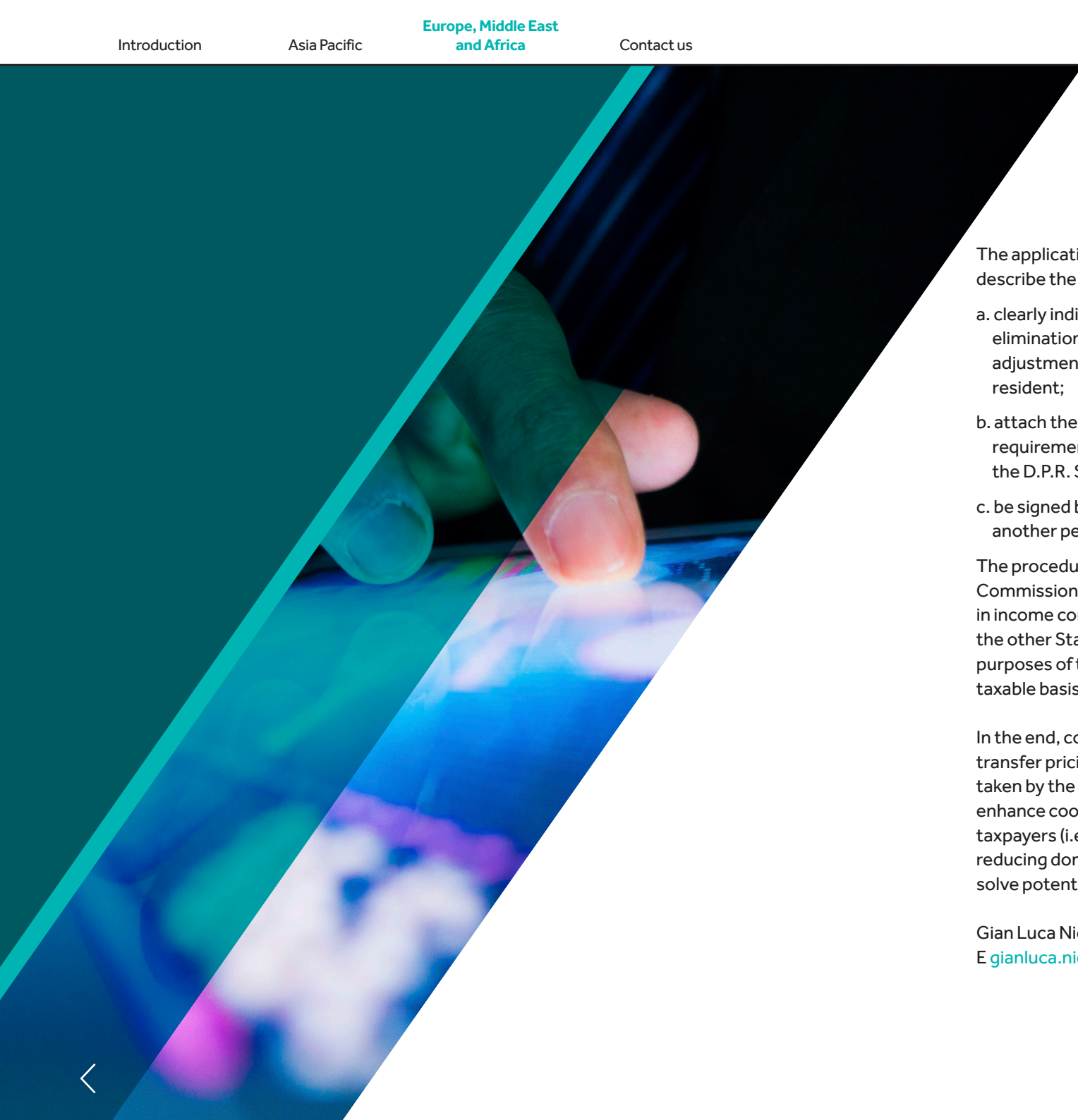
### Downward corresponding adjustments

A few days later, on 30 May 2018, the Revenue Agency published guidelines (Provvedimento del Direttore

dell'Agenzia delle Entrate n. 108954/2018) defining the procedure contained in the article 31-quarter of the Decree of the President of the Republic 600 of 1973, concerning downward corresponding adjustments. Specifically, a recognition for Italian tax purposes of the corresponding decrease in income operating according to Article 110, paragraph 7, can be implemented locally through the presentation of a specific request to the Italian Central Revenue, provided that the adjustment raised in another State is definitive and in accordance with the arm's length principle. Moreover, it is requested that Italy has signed a double tax treaty with that State and an adequate exchange of information is granted.

The procedure can be activated by all entities that are resident in Italy and belong to a multinational group, or operate abroad through a permanent establishment, as well as by no-residents who carry out their business in Italy through a permanent establishment. The request has to be submitted to the specific department of the Central Revenue in Rome dedicated to APAs and MPAs (so called Ufficio Accordi Preventivi e Controversie Internazionali). The application requires the activation of the procedures for the resolution of international disputes and the application must be submitted within the deadlines set by the legal instrument for the resolution of international disputes indicated therein, so three years for the EU Arbitration Convention or within the deadline set by the specific double tax treaty for the MAP.





The application shall provide elements required to properly describe the litigation and in any case has to:

- a. clearly indicate the subject matter, i.e. the request for the elimination of double taxation generated by an upward adjustment in the foreign country where the related entity is resident;
- b. attach the documentation, suitable to prove possession of the requirements of letter c), paragraph 1 of the art. 31 quater of the D.P.R. September 29, 1973, n. 600;
- c. be signed by the legal representative of the company or by another person with the powers of representation.

The procedure is finalized by a formal act of the Revenue Commissioner which disposes for the downward adjustment in income corresponding to upward adjustment carried out in the other State. Accordingly, through the recognition for local purposes of the adjustment raised in another State, a revised taxable basis will be identified.

In the end, considering the renewed international debate around transfer pricing generated by the BEPS Project, current initiatives taken by the Italian Revenue witness a remarkable effort to enhance cooperation between the tax administration and taxpayers (i.e., multinational enterprises, in this case) in the aim reducing domestic controversy and implementing new tools to solve potential double taxation issues.

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# Poland

## New Transfer Pricing regulations in Poland

Starting from January 2017 amended regulations with respect to transfer prices entered into force. These rules impose multiple new obligations on the taxpayers who execute transactions with related parties (exceeding statutory thresholds). 2017 is the first year which should be documented according to the new regulations. The deadline for fulfilling new obligations expires, as a rule, on the date for submitting the annual tax declaration (end of third month following given tax year). However, for the documentation of 2017 and 2019 the deadline is postponed until ninth month following the tax year.

Until 2017 Polish regulations required only local file to be prepared for qualified transactions. There was no filing obligations, documentation was presented to the tax authorities upon request. In the case when taxpayer was unable to satisfy such request and transaction was not compliant with arm's length principle additional tax was calculated according to the penalty 50% CIT rate.

After 2017 discussed obligations are significantly extended. Under new regulations, qualified taxpayers should prepare the documentation for the transactions with related parties which has significant impact on reported profit or loss.

Qualified entity is a taxpayer who reported in the previous year at least EUR 2m of revenues or costs. Volume of

the transaction which is considered as having significant impact is set at the level of EUR 50k and is growing gradually with reported revenues or costs.

The obligation depends on the level of reported revenues or costs, the taxpayer with revenues or costs from EUR 2m to EUR 10m will be required only to prepare a local file. At the level between EUR 10m to EUR 20m obligation comprises of local file, benchmarking study and special CIT-TP report filed with the tax authorities. Entities exceeding the threshold of EUR 20m has to prepare additionally master file disclosing inter alia group transfer pricing policy, structure and functions allocated across the group. For the biggest taxpayer with consolidated revenues above EUR 750m there is also so called country by country reporting obligation – simplified report disclosing revenues and costs reported by the companies from group.

Based on the new regulations obligation lasts for two years, therefore in the case when threshold is reached for 2017 (based on the revenues or costs of 2016) also 2018 must be documented.

There is also a specific regulation allowing the tax authorities to oblige the taxpayer to prepare the documentation even in the case when materiality level and transfer pricing threshold is not reached. Such possibility exist when there are circumstances suggesting that given related party transaction is not compliant with

arm's length principle, in this case deadline for presenting the documentation is 30 days.

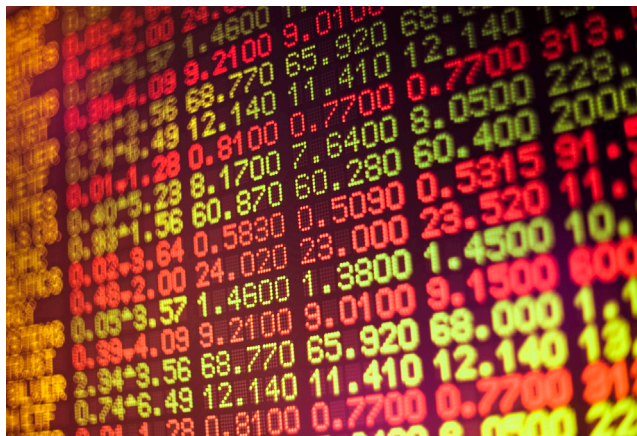
When establishing scope of the transfer pricing obligation key challenge is to determine whether given transaction should be perceived as material (having significant impact on the profit and loss of the taxpayer).

As material transaction should be treated primarily those transactions or other events of one kind, the total value of which exceeds in the tax year the equivalent of:

- For the entities reporting revenues and costs between EUR 2m and EUR 20m materiality is EUR 50k plus EUR 5k for each m above EUR 2m.
- In the range between EUR 20m and EUR 100m materiality level should be calculated as EUR 140k plus EUR 45k for each EUR 10m above EUR 20m.
- For the taxpayers exceeding EUR 100m materiality level is EUR 500k.

This threshold should be applied to the transactions of one kind. Taxpayers still have difficulty in determining how the value of transaction or event of one kind should be established. Due to numerous doubts, on January 24st, 2018, a general ruling was issued by the Minister of Finance, referring to the manner of determining the value and definition of transactions and other events of one kind.

According to the view presented by the Minister of Finance, the threshold of the transaction value or other event, specified in the regulations should be referred separately to each kind of transaction or each kind of other events taking place in relations with the entity. This threshold should not be referred separately to each transaction and any other event. In practice, this means that if the taxpayer has concluded several transactions or there are several events, each of which is separately below the materiality threshold, he may still be required to prepare documentation for them - in a situation where, after adding up the value of transactions (events) of the same type, the sum exceeds the set thresholds.



A very important conclusion resulting from the ruling of the Minister of Finance concerns cases where transactions of the same type are concluded or other events of the same type occur, but with various related entities. In such a situation, the threshold should be related to the sum of transactions (events) of one kind concluded with all related entities. This is a different view from that presented so far by tax authorities, which suggested that excess of the thresholds should be verified only with a given entity.

However, despite the above-mentioned general ruling, it is still problematic to determine what should be understood under the term "transactions or other events of one kind". Should this phrase be referred to the division into merchandise, service, financial and low value-added transactions? Or maybe transactions should be analyzed at a higher level of detail and additionally divided into sales and purchase transactions? Or maybe it is necessary to distinguish specific types of transactions and other types of events and instead of classifying them as financial transactions, the threshold value required to prepare a documentation should be referred separately to individual financial transactions, such as a loan, bank account, sale of derivatives. Tax rulings do not indicate clearly the correct answer. It depends in each case on the types of transactions (or other events) concluded by the taxpayer.

The general ruling also refers to the issue of generic grouping, but it does not give sufficiently clear answers. According to the standpoint of the Minister of Finance, in order to aggregate particular transactions or other events as part of one type, transaction parameters relevant for transfer pricing should be taken into account, e.g. key functions performed, assets involved, risks borne, the method of price calculation or material terms of payment. Only after taking into account these parameters, it is possible to distinguish the types of transactions (or other events) taking place within the activity of a taxpayer and verify if they are subject to the documentary obligation.

Above discussed aspect is only one example of controversial and difficult aspect which forces the tax authorities to issue general tax ruling. New regulations still require further amendments and official interpretations of Ministry of Finance. Nonetheless deadline for preparation of first documentation falls at the of September 2018.

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# Switzerland

## Decision of the Administrative Court Zurich regarding cash pooling

Cash pooling arrangements have been under scrutiny by Swiss tax authorities for quite some time now. Typically, challenges concern the distinction between cash pool receivables and long-term loans and/or the acceptance of interest rates applied. On 7 December 2016, the Administrative Court Zurich addressed these aspects in its judgment (SB.2016.00008).

### Background

A Ltd., an operating company located in Switzerland is part of a multinational group. The group has a finance company located in the United Kingdom that is responsible for global treasury, incl. the management of the group-wide cash pool. Funds can also be deposited with the finance company for a longer term at corresponding higher interest rates.

As part of a tax audit in Switzerland, a portion of the cash pool receivable of A Ltd. was treated as a long-term loan subject to higher interest rates. The reason behind the requalification was that the cash pool receivable of A Ltd. was significantly positive over a long period. As the decision of the tax authorities was largely confirmed during the appeals process, the case was brought to the Administrative Court Zurich.

### Considerations of the Administrative Court

Distinction between cash pool receivables and long-term loan receivables: In the Administrative Court's evaluation of a potentially necessary distinction between cash pool receivables and long-term loan receivables, the court referred to key figures for liquidity such as the quick ratio that might be used as an indicator to assess the surplus liquidity of a company. The court concluded that liquid assets exceeding minimum liquidity typically required in practice might require a conversion of a portion of the cash pool receivable into a long-term loan receivable. During the years under review A Ltd. had cash pool receivables amounting to approx. 70% (and 84%, respectively) of its total assets, which was further considered a cluster risk by the court in accordance with jurisprudence. Apart from that, A Ltd. only had very limited liquidity available outside the cash pool.

Considering overall circumstances, the court came to the conclusion that the amount of the assets invested by A Ltd. in the cash pool did not keep to the arm's length principle. As a result, the requalification of a portion of the cash pool receivable into a mid- or long-term loan was considered correct.

The Administrative Court further made a few considerations on how the portion of the cash pool receivable to be requalified needs to be determined.

The minimum balances of the cash pool receivable at the beginning and at the end of the year can serve as a starting point as a purely retrospective assessment is not considered appropriate. In addition, a bandwidth must be considered to reflect planning uncertainty. This bandwidth is to be determined from the average balance of the cash pool receivable and will in a further step be deducted from the minimum balance during the year. Like that, the long-term portion of the cash pool receivable is determined. However, the court did not conclude on the appropriate bandwidth or margin, i.e. it referred the case back to the lower instance to determine such margin (on a case-by-case basis).

### Interest rate

For the portion of a cash pool receivable that has been requalified into long-term loan along the guidelines above, long-term interest rates need to be applied. In the case at hand, the evidence of the arm's length nature of the interest rate that would have been available for deposits up to twelve months within the group brought forward by the taxpayer was accepted. So, the higher safe haven interest rates according to the circular of the Swiss Federal Tax Administration were not applied.

After all, this resulted in an income tax adjustment (i.e. deemed dividend) in the difference between the cash pool interest rate applied and the interest rate available for long-term deposits within the group on the requalified portion of the cash pool receivable.



## Conclusion

Contrary to the expectations, the decision of the Administrative Court Zurich is not final. It is expected that the case will be taken to the Federal Supreme Court. However, it remains to be seen if and to what extent the Supreme Court will comment on the aspects above.

Considering the judgment of the Administrative Court Zurich, it is strongly recommended that multinational groups with cash pool arrangements regularly monitor the development of the cash pool receivables of Swiss entities. In case of substantially positive balances over a longer period, it might be required that a portion of the cash pool receivable is converted into a long-term loan subject to higher interest rates.

At the same time, it is of increasing importance that companies fulfill their compliance obligations and are in the possession of comprehensive transfer pricing documentation to defend the arm's length nature of the interest rates applied.

What needs to be kept in mind is that deemed dividends to sister companies are subject to Swiss withholding taxes of 35%. Due to the peculiarities of the Swiss withholding tax, this results in a withholding tax leakage as only a partial reclaim of withholding taxes is available in such situations based on the applicable double tax treaty.

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# Tanzania

## The transfer pricing framework

### Background

With the evolution of international tax regimes and the increasing globalization of multinational corporations has left numerous gaps in local country tax laws around the world. This has given multinational enterprises ("MNE") the ability to artificially reduce, and even eliminate, their corporate tax burden through "artificially" shifting profits to low or no-tax jurisdictions where there is little or no economic activity through transfer pricing.

### Introduction in Tanzania

On 7 February 2014 the Government of Tanzania published The Income Tax (Transfer Pricing) Regulations under the Income Tax Act through Government Notice No. 27 in an attempt to reduce tax avoidance. These regulations expand on the rules found in section 33 of the Income Tax Act that deal with transactions between related persons.

These regulations govern the procedures for applying the arm's length principle and specify the appropriate transfer pricing methodologies, documentation requirements, deadlines and penalties.

In view of the regulations, companies that transact with related entities both in and outside Tanzania will be required to put in place a robust transfer pricing policy that supports their transactions using one the accepted transfer pricing methods provided for by the regulations.

### Transfer pricing in practice

To justify that the transaction with the related party is in accordance with the arm's length principle, a transfer pricing study is usually conducted. In conducting a transfer pricing study, one looks at the following:

- Industry analysis
- Functional analysis
- Selection of method
- Economic analysis

### Characterisation

The conclusions from the above are used to characterise an entity into a certain functionality. Why do we characterise entities for transfer pricing purposes?

- To utilize a common taxonomy
- To select and apply the appropriate transfer pricing methodology to the appropriate tested party

### Selection of methods

After characterising a company, the most appropriate transfer pricing method needs to be selected such as:

a. Traditional transaction methods:

- Comparable Uncontrolled Price Method (CUP);
- Cost Plus (CP); and
- Resale Price Method (RPM).

b. Profit methods:

- Profit Split Method (PSM); and
- Transactional Net Margin Method/ Comparable Profits Method (TNMM).

### Documentation requirements

- According to the Income Tax (Transfer Pricing) Regulations, 2014, Section 7;
- Any person participating in a controlled transaction shall prepare contemporaneous transfer price documentation. (\* Controlled transaction means a transaction between associates)
- The contemporaneous documentation shall include records and documents that provide description of the following:
  - a. Organization structure, including an organization chart covering persons involved in a controlled transaction;
  - b. Nature of the business or industry and market conditions;
  - c. The controlled transactions;
  - d. Strategies and assumptions regarding factors that influenced the setting of any pricing policies;
  - e. Comparability, functional and risk analysis;
  - f. Selection of transfer pricing method;
  - g. Application of the transfer pricing method;
  - h. Documents that provide the foundation for or otherwise support or were referred to in developing the transfer pricing analysis;
  - i. Index to document; and
  - j. Any other information, data or document considered relevant by the commissioner.
- The documentation for a year of income shall be in place prior to the due date for filing the income tax return for that year.

- The documentation shall, upon request by the Commissioner be submitted within thirty days from the date of request.

### Transfer Pricing Risk Areas (TP Risk Flags)

- a. Intellectual Properties
  - Companies paying large management fees
  - Companies paying royalties or other charges for the use of intellectual property
- b. Structural issues
  - Companies with innovative business structures
  - Transactions with tax havens or shelters
  - Loss making companies in commercial relationship with taxpayer where the loss is as a result of payments to that entity
- c. Losses
  - Companies making losses over a number of years
  - Sustained losses by Tanzanian entities, but (overall) profits in the group
  - Margins suddenly decrease with no rationale
- d. Finance
  - Debt levels, intra-group loans and guarantees that are 'un-commercial'
  - No formal agreement for services or finance provision with no recharge of costs
  - Secondments undertaken on 'un-commercial' terms (i.e. no recharge and no agreements)
  - Trading debtor balances – intercompany, long term, interest free

### Penalties and Fines

According to the Income Tax (Transfer Pricing) Regulations, 2014; Section 5; A person who fails to comply with these regulation commits an offence and is liable on conviction to imprisonment for a term not exceeding six months or to a fine not less than Shillings fifty million shillings or to both.

In addition, the penalty for any transfer pricing adjustment made as part of a tax audit is 100% of the underpayment of tax.

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# United Kingdom

## MLI: UK Update

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) has now been ratified and the notification was sent to the OECD on 29 June 2018.

The MLI will enter into force in the UK on 1 October 2018. The MLI will only have effect for double taxation agreements that have been listed as covered agreements by both the UK and the relevant treaty partner, with the date of effect for such a treaty being determined by reference to the later of the dates that the MLI enters into force for both treaty partners. Changes to the UK's treaties cannot take effect before 1 January 2019 in relation to withholding taxes and 1 April 2019 for all other taxes, although the arbitration provisions may apply earlier.

The MLI will bring in a Principal Purposes Test ("PPT") and is likely to result in increased focus on the purpose of structures and transactions by tax authorities, even where there was a PPT in the relevant treaty. Businesses should not rely upon the fact that challenges have not been raised historically and should undertake a review of the existing position to avoid future challenges from the Tax Authorities.

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